

UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT

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No. 82-

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In the Matter of:	*	Appeal from the United
Chicago, Milwaukee,	*	States District Court for
St. Paul & Pacific Rail-	*	the Northern District of
road Company, Debtor.	*	Illinois, Eastern Division
	*	No. 77-B-8999
Appeal of State of South	*	Thomas R. McMillen,
Dakota, etc.	*	Judge.

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Submitted: July 30, 1982\*

Filed: September 3, 1982

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Before CUMMINGS, Chief Judge; BAYER and  
COFFEY, Circuit Judges.

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ORDER

The Chicago, Milwaukee, St. Paul and Pacific  
Railroad Company (the "Milwaukee Road") filed

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\* Pursuant to this court's order of October 29,  
1981, upon joint motion of the parties to waive  
oral argument, this appeal is submitted to the  
court on the briefs and record. See Circuit  
Court Rule 14(f).

for reorganization under § 77 of the Bankruptcy Act, 11 U.S.C. § 205 (1976), on December 19, 1977. On December 20, 1977, the Reorganization Court entered "Order No. 1" in the case. Paragraph 10 of that order provided for a stay of all proceedings against the Milwaukee Road, in accordance with Bankruptcy Rule 8-501. Among other things, paragraph 10 enjoined "the setoff of any obligation to the Debtor against any claim owing by the Debtor. . . ." In addition, in paragraph 4B of Order No. 1, the court gave the Trustee of the Milwaukee Road discretion to pay or withhold payment of "taxes, assessments and other governmental charges . . . ."

Pursuant to his authority under Order No. 1, the Trustee has deferred payment of taxes, for the years 1977 and 1978, to 43 South Dakota counties. By operation of South Dakota law, these counties became lien creditors when the

railroad failed to pay the taxes.<sup>1</sup> Twenty-nine of the creditor counties owe tax refunds to the Milwaukee Road.<sup>2</sup> Rather than pay the full amount of the refunds, these counties wish to set off the back taxes owed to them against the refunds owed by them. Because such setoffs are precluded in paragraph 10 of Order No. 1, South Dakota filed suit on behalf of its counties, seeking relief from the injunction against setoff.<sup>3</sup> The Trustee filed an answer supporting the setoff

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<sup>1</sup> The Trustee concedes that the counties are secured creditors "for purposes of argument only." Appellees' brief at 9.

<sup>2</sup> On November 23, 1977, the South Dakota Department of Revenue issued a directive stating that the Milwaukee Road had overpaid ad valorem taxes for the years 1969 and 1970. The directive ordered the counties that had received the overpayments to refund the money to the railroad. Although some counties complied with this directive, twenty-nine have not done so.

<sup>3</sup> In its complaint, South Dakota also requested judgment in favor of all 43 counties to which the Milwaukee Road owes back taxes. The district court denied such relief. South Dakota has not contested this aspect of the court's order, and it is not addressed here.

injunction, and filed a counterclaim demanding payment of the tax refunds still owing to the Milwaukee Road.

The district court granted summary judgment to the Trustee, refusing to lift the setoff injunction and ordering immediate payment of all tax refunds owed to the Milwaukee Road. South Dakota appealed.

South Dakota's sole ground for appeal is that the district court should have granted a setoff to the tax-creditor counties because the refusal to grant the setoff "violates the principles set forth in the case of Baker v. Gold Seal Liquors, 417 U.S. 467 (1974)." Appellants' brief at 5. We reject this argument.

In Baker, the trustees of the Penn-Central Transportation Company sued respondent for freight charges. Respondent counterclaimed for cargo loss and damage. The district court found in favor of the trustees on the freight-charge

claim and in favor of the respondent on the cargo-loss claim. Over the objection of the trustees, the district court set off one judgment against the other. The Supreme Court reversed, holding that "[a]s a general rule of administration," a setoff should not be allowed in railroad reorganization proceedings under section 77 of the Bankruptcy Act. Id. at 474. The Court reasoned that granting a setoff would grant "a preference to the claim of one creditor over the others by the happenstance that it owes freight charges that the others do not. That is a form of discrimination to which the policy of § 77 is opposed." Ibid.<sup>4</sup>

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<sup>4</sup> Discussing the policy of § 77, the Court explained that the aim of the Reorganization Court is by financial restructuring to put back into operation a going concern, and that this aim entails two basic considerations:

First is the collection of amounts owed the bankrupt to keep its cash inflow sufficient for operating purposes, at least at the survival levels. The second

South Dakota argues that Baker's general rule against allowing setoffs in railroad reorganization cases is not applicable here, for two reasons. First, the state asserts, denial of the setoff would deprive the counties of their secured-creditor status. The appellant, however, offers no support for this bald conclusion. The counties' liens on the Milwaukee Road's real property arose by virtue of the railroad's failure to pay taxes when due. That those same counties owe offsetting refunds to the railroad can have no effect whatever on the existence or validity of the tax liens. It follows that the district court's decision that the refunds must be paid in full has no effect on the existence or validity of the tax

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is to design a plan which creditors and other claimants will approve, which will pass scrutiny of the Interstate Commerce Commission, which will meet the fair-and-equitable standards required by the Act for court approval, and which will preserve an ongoing railroad in the public interest.

Id. at 470-71 (footnotes omitted.)

liens. The counties remain secured creditors; their claims are being treated no differently from the claims of other similarly situated secured creditors.

South Dakota's second argument is that setoff should be granted because it would not result in an unfair preference. This argument reveals the state's misapprehension of the Supreme Court's reasoning in Baker. South Dakota apparently believes that in Baker, granting the setoff to the unsecured creditor resulted in elevating the unsecured creditor to the status of secured creditor, and that this elevation was the "preference" condemned by the Supreme Court. This view is erroneous. The allowance of the setoff in Baker gave the unsecured creditor no security interest in any property of the railroad, but rather gave it the equivalent of immediate payment on part of its claim against the railroad. The "preference" consisted of giving immediate payment to one unsecured creditor while denying

immediate payment to other unsecured creditors. In the present case, granting a setoff to the South Dakota counties would result in a similar preference: the South Dakota counties would receive, effectively, immediate payment on part of their tax claims, while other entities with similar claims secured by liens would not receive immediate payment.

Finally, South Dakota argues that the Trustee's asserted need for cash is insufficient to justify denial of the setoffs because it is "hardly a controlling consideration under the principles enunciated in Baker." But in Baker, the Supreme Court expressly stated that one of the two basic considerations of a Reorganization Court is "the collection of amounts owed the bankrupt to keep its cash inflow sufficient for operating purposes, at least at the survival levels." Id. at 471. Moreover, the Reorganization Court in this case did not, as South Dakota asserts, determine that the Milwaukee Road's asserted need for cash

justified a denial of the South Dakota counties' secured-creditor status. As discussed above, denial of the setoffs does not undermine that status. To the contrary, it ensures that the South Dakota counties will be treated the same as other secured creditors who do not happen to owe money to the railroad. This is the proper result under Baker.

For the foregoing reasons, the judgment of the district court is affirmed.